

Current Stabilization Policy

THE NATIONAL ECONOMY is confronted with two major problems — inflation and unemployment — and for the first time since 1957 and 1958 both problems must be dealt with simultaneously. The course of events which brought the economy to this juncture includes the monetary and fiscal actions of the past five years.

Until mid-1970, rising unemployment did not appear to many analysts to be a major problem for the economy. The rise of unemployment in the first half of 1970, compared to 1969, was viewed as a temporary effect of a moderated growth of total demand and as a necessary cost of establishing price stability. It was recognized that a somewhat higher and gradually rising level of unemployment was to be expected for a short time, as a result of applying more restrictive stabilization actions in hopes of achieving a relatively stable price level. By the autumn of 1970, however, unemployment had risen more than most analysts expected.

Recent Developments

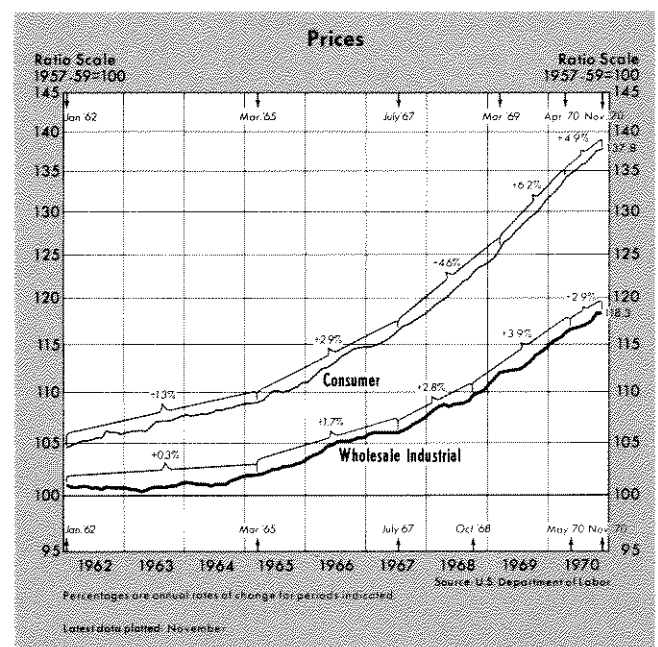
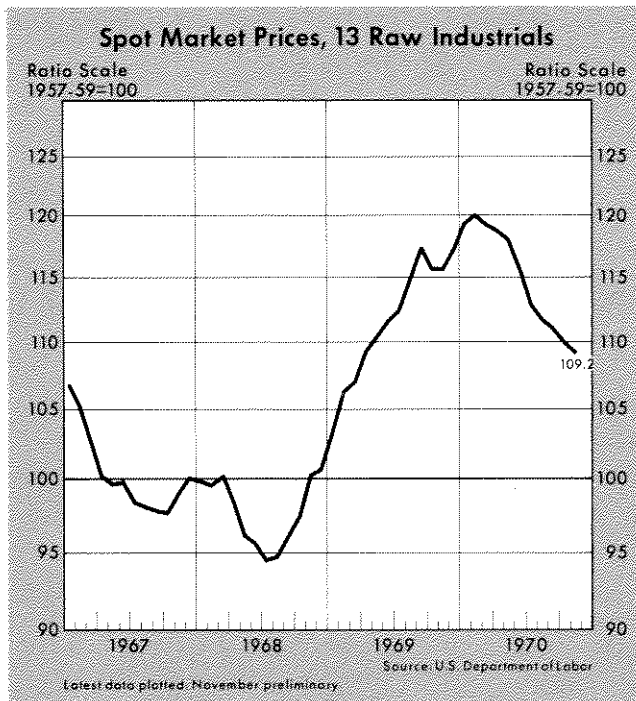
Recent Price and Employment Trends

The gradual moderation of the pace of price increases in 1970 was similar to price trends during

other post World War II periods when the growth of total spending slowed. The growth rate of raw industrial material prices rose steadily in the last half of 1968 and 1969, reaching a peak in 1970. The growth of wholesale industrial prices and consumer prices reached peaks in the first half of 1970.

Since February 1970, the prices of raw industrial materials have declined at an 11.7 per cent annual rate. While these prices are highly responsive to changing demand and supply conditions, their decline should not be viewed as conclusive evidence that substantial improvement in inflation will follow. The decline reflects international as well as domestic market conditions.

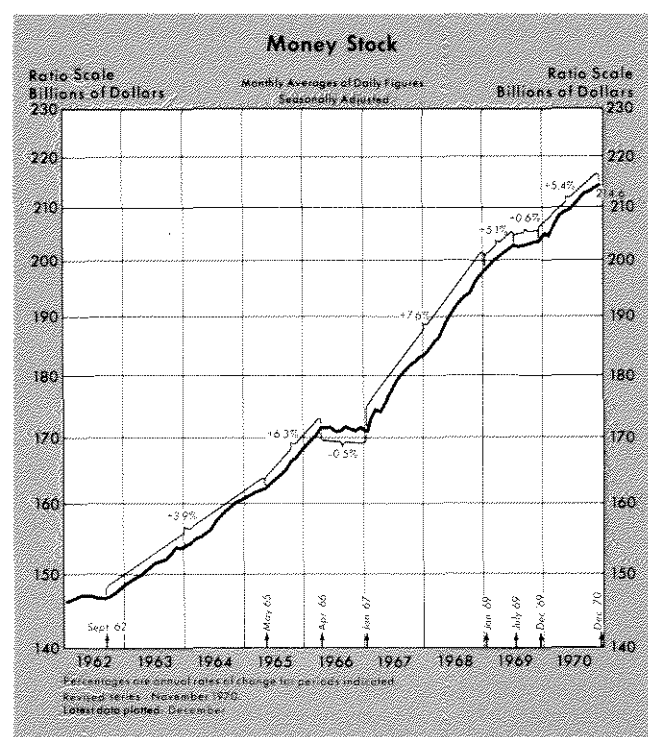
Wholesale prices of industrial commodities rose at a 3 per cent annual rate from May to December, down from the 3.9 per cent increase in the preceding twelve months. Wholesale prices of farm products and processed foods and feeds declined slightly over the year ending in December, but these prices frequently reflect special supply conditions, and for short periods of time often follow trends independent of business fluctuations in the economy. Consumer prices have moderated since last April, rising at a 4.9 per cent annual rate to November, compared with a 6 per cent increase in the previous twelve months.



Slower growth in total spending and a growing labor force resulted in a rising unemployment rate in 1970. Unemployment reached 6 per cent of the labor force in December, compared with a 3.9 per cent rate in January 1970. The average duration of unemployment increased from approximately 7.8 weeks late in 1969 to 9.2 weeks in the last quarter of 1970.

Monetary and Fiscal Developments

The money stock rose 5.4 per cent from December 1969 to December 1970, compared with 3 per cent in 1969.¹ In 1967 and 1968, when inflationary pressures were intensifying, money expanded at about a 7.2



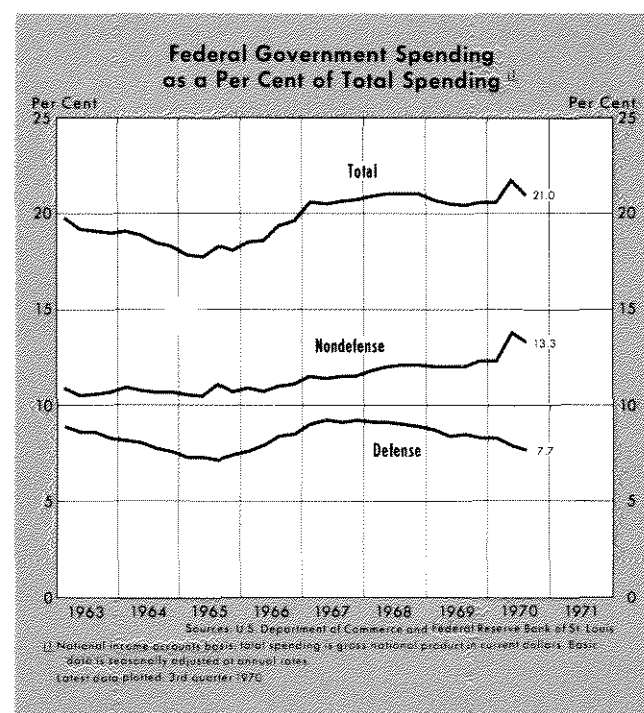
per cent annual rate. Time deposits have increased at a rapid 23 per cent rate since February, to a large extent the result of reintermediation associated with the substantial decline in market interest rates this year, and relaxation of Regulation Q ceilings on the rates banks were permitted to pay on time deposits.

Several budget actions in 1970 contributed to increases in disposable personal income. A 6 per cent pay increase for Federal employees and an increase in the Social Security benefit schedule were enacted into law, both retroactive to the beginning of the year.

¹See "The Revised Money Stock: Explanation and Illustrations" on pages 6-15 of this *Review*, for a discussion of the recent revisions of money stock data.

The tax surcharge was reduced to 5 from 10 per cent on January 1, 1970, and expired on June 30. These actions, together with lower-than-anticipated tax receipts associated with the economic slowdown, resulted in a swing in the national income accounts budget from a surplus of \$9.3 billion in the calendar year 1969 to a deficit at an \$11.9 billion annual rate in the third quarter of 1970.

Federal budget trends and priorities of the past decade can be seen in the accompanying chart. Total Federal spending increased from 18 per cent of total spending in 1965 to an average of 21 per cent for the years 1967 to 1970. Government spending for defense and defense-related programs increased from 7 per



cent of total spending in 1965 to 9 per cent in 1968, and then declined to slightly less than 8 per cent in 1970. Since 1968, nondense spending as a proportion of total spending in the economy has expanded by an amount slightly greater than the decline in defense spending as a proportion of total spending, so that total Federal spending in 1970 were slightly higher than in 1969.

Policy Dilemma

The problems facing stabilization authorities are substantially different now than a year ago. At the end of 1969 there was little question that inflation was the most important problem facing economic policymakers. A year later the rate of price increase (as

measured by the GNP implicit price deflator) had declined to about a 4.5 per cent annual rate, while unemployment as a per cent of the civilian work force had risen from 3.5 per cent to 6 per cent.

Few economic analysts would argue that the effort to eliminate inflation should be abandoned to give full attention to preventing further increases in unemployment. Similarly, few analysts would propose that the level of unemployment should be disregarded and that any amount of idle work force should be allowed to occur, while the remaining forces of inflation are purged from the economy. The approach to economic stabilization taken in view of these circumstances will depend on the consensus of policymakers regarding two questions: how long will it be before the rate of inflation subsides substantially if the policies of 1970 are continued in 1971; and what will be the likely path of the unemployment rate in the interim? If the time span required to stem inflation is considered to be too long, or the contemplated average level of unemployment is deemed to be too great, alternative policies would be recommended by some. However, an assessment of the most probable results of continuing recent past policies should be made, before alternative courses are proposed.

A position which favors continuing the policies of 1970 is based to some extent upon the assumption that people still anticipate rapid inflation, on the basis of the last five years of inflation. Further, it is argued that the current slowdown in business activity and the associated rising unemployment were to be expected and were necessary in order to eventually achieve a continued reduction of the rate of inflation. It is probably neither desirable nor necessary, according to this view, to reduce the rate of growth of total demand for goods and services in the future below the rate of 1970. A substantial and prolonged increase in the growth of total spending from the present rate, initiated by expansive monetary and fiscal actions, would preclude further progress in controlling inflation.

A second position, which favors emphasizing a reduction in unemployment as the primary objective of stabilization policy, argues that stabilization actions to stimulate total spending would promptly accelerate the growth of production and employment. Since there currently exists excess labor and capital equipment, it is argued that such stimulation would result in little interruption in the rate of price decline. Only when the gap between actual and potential output is sub-

stantially narrowed, it is contended, would there be a danger of adding to inflationary forces.

The difference between these positions depends on the weighting of economic objectives and the choice of a time horizon in which to achieve the objectives. If a decline in unemployment is the dominant, but not the exclusive, objective of stabilization policy, the goal of relative price stability will probably have to be sacrificed in the near-term. If the reduction of inflation is the dominant, but not the exclusive, objective of policy, a quicker reduction in inflation might be obtained at the expense of temporarily higher unemployment.

There is little direct historical evidence as to the types of actions which are best suited to deal simultaneously with the problems of inflation and unemployment. Indirect evidence of the likelihood of certain outcomes of various policy alternatives, however, can be obtained from statistical studies of historical relationships among economic magnitudes. Implications from such studies indicate the most probable response of the economy to alternative stabilization actions.

The results of recent studies by this Bank indicate that a growth of the money stock at a 5 per cent rate in 1971 would imply a 7 per cent increase in nominal GNP for the four quarters of 1971. A price rise of about 4 per cent and an unemployment rate of about 6 per cent would be associated with this rate of growth of total spending during 1971. Beyond 1971, a continuation of a 5 per cent rate of growth of money would be conducive to further reduction in the rate of inflation and some improvement in the level of unemployment.

By comparison, an 8 per cent rate of increase in the money stock during 1971 most likely would be associated with about a 9 per cent rate of growth of total spending, a 4.4 per cent rate of increase in prices, and a 5.7 per cent unemployment rate. The rate of inflation would remain high beyond 1971, even if a slower growth in money were sought after 1971.

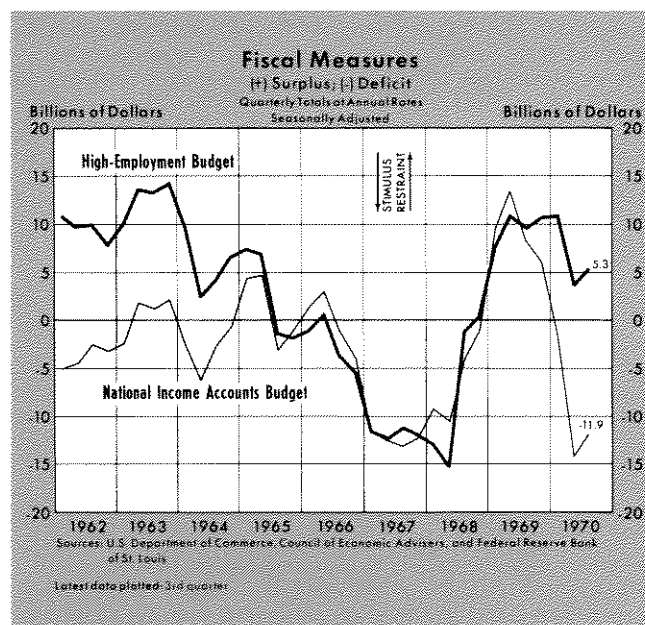
Strategies for Policy in 1971

Some persons who desire "full" employment within the next year or two have suggested that it would be desirable for real output to rise at about an 8 per cent annual rate until full employment is achieved. It is doubtful that this goal is attainable, given the current state of the economy and the lagged effects of past actions. Moreover, such a rapid expansion would

probably revive expectations of rapid inflation, which would cause substantial problems for stabilizing the price level in the future. The course suggested to attain the 8 per cent real growth would be to maintain or accelerate the growth in Federal expenditures, which would result in a \$15 to \$20 billion budget (NIA) deficit in 1971 (but a near balance on the high-employment accounts budget). The deficit might be financed, in large part, by a more rapid monetary expansion.

This expansive policy has appeal for those with short time horizons for evaluation. However, when judgment includes the effects beyond the present year or so, the more expansionary course is not so clearly desirable. The more moderate course, of continuing through 1971 to expand the money stock at about the same rate achieved in 1970, would be conducive to continued reduction in the rate of inflation while allowing a resumption in the growth of real product.

Inflation and inflationary expectations should continue to have a bearing on stabilization policy, although this concern is likely to be tempered by greater attention to unemployment than was the case only three or four months ago. Relaxation of stabilization



policies and resulting increased growth in spending will cause a lengthening of the waiting period necessary to stem inflation. If the relaxation is great, substantial spending increases may cause further inflation, with employment benefits and increased growth of real output only temporary.

